

# INVESTMENT STRATEGY QUARTERLY

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# Letter from the Chief Investment Officer Sailing on Strange Seas

Investors had gotten used to smooth sailing with the economy remaining resilient, the equity market soaring double digits, and volatility remaining (mostly) subdued. But as we extend our voyage into unknown seas, we will need to maintain a steady hand on the tiller, recalling the old sailing motto that “*The good seaman weathers the storm he cannot avoid, and avoids the storm he cannot weather.*” So come sail away with me as we use eclectic sailing references to outline our views for the economy and financial markets to chart their course for the remainder of this year and 2024.

While Federal Reserve (Fed) Chairman Powell is not officially a sailor, he is the proverbial captain of the US economy as the Fed’s actions have a major impact on its direction. And given the unprecedented way this economy has reacted to COVID, the Fed’s traditional GPS readings have been less reliable. Ironically, Powell sounded like an old salt himself when he recently said the Fed is “navigating by the stars under cloudy skies.” To his point, consumer spending has been robust, especially during the summer as consumers spent like drunken sailors on travel and leisure. But just like you don’t sail a boat backwards, you can’t determine the direction of the economy by looking behind you. And from our vantage point, a consumer spending fog is rolling in as job growth slows (turning negative in 2024), excess savings disappear, and borrowing becomes more costly. While government spending on infrastructure has helped buoy the economy, it will likely not be enough to offset the decline in consumer spending. As a result, we estimate the US economy will have a mild recession in the first part of 2024 before rebounding in the second half. As a result, 2024 GDP will notch a small 0.4% growth rate—so not a disaster.

Given this economic outlook, we expect the Fed is nearing the end of its tightening cycle, with possibly one last interest rate hike this year. Its goal of submerging inflationary pressures is on course and will gain momentum reinforced by lower shelter costs as we progress through 2024. The headwind of challenging growth amid decelerating inflation should allow the Fed to begin cutting interest rates around mid-year next year. What could cause a broken mast and shipwreck the economy? The Fed crying out like the famous commander David Farragut to “Damn the torpedoes! Full speed ahead!” If the Fed is overzealous lifting interest rates higher than we forecast or if they do not proactively cut rates to put a breeze into the sails when needed, it could cause a deeper recession. Oil prices surging sustainably above \$100/barrel and

dampening consumer confidence and spending power is also a risk on our radar. Fortunately, neither of these more severe scenarios are on our expected route.

For the fixed income market, the famed merchant and occasional sea traveler Marco Polo comes to mind. Legend has it that, while traveling to China, he got separated from his family. When they called for him as ‘Marco!’, he reportedly responded ‘Polo!’—just like in the pool-based game. Like his family (and the closed-eyed player in the game), we keep searching and ‘calling out’ for lower interest rates. But like the open-eyed players, they remain elusive—and at elevated levels. However, we’re still sailing steadily toward a prediction that the 10-year Treasury yield will ‘tag’ 3.5% over the next 12 months. Persistent recessionary concerns, falling inflation, and record shorting of the bond market should support interest rates moving lower. We’re focused on the pool of Treasuries, high quality corporate bonds and municipals. Swimming in both the short end (shorter maturities) and deep end (longer maturities) of the pool remains of value. But over the next six to nine months, investors should transition to the deeper part of the pool. The fish out of water that we remain cautious on are higher risk, high yield bonds that do not hold a favorable risk/reward profile at current levels.

For the equity market, we turn to a hero of our youth, Popeye the Sailor. For those too young to remember, Popeye appeared weak ... until transformed by his secret strengthener: a can of spinach. Typically, market performance is driven by the ‘spinach’ of earnings growth, but, paradoxically, equities’ almost 13% return this year has been driven by price/multiple expansion, which is a measure of sentiment, not underlying fundamentals. In fact, 2023 earnings growth for the S&P 500 is a puny 2%. To strengthen the current market rally, companies will have to ‘eat their canned spinach’—that is, grow earnings. But a good can of earnings growth

might be hard to find. Next year's challenging economy will make top line sales growth difficult and will force companies to manage their expenses to maintain their margins. We do not expect corporate earnings to slip precipitously, but rather tread water around the \$220 level in 2024, supporting our more subdued 12-month S&P 500 target of 4,650. A healthy appetite for spinach will likely not be until 2025.

One important characteristic of Popeye was his loyalty, especially to his wife, Olive Oyl, and his adopted son, Swee'Pea. Similarly, we remain committed to our equity and international preferences from the previous quarter. Within the US equity market, we favor the Technology, Health Care, Financials and Energy sectors. These sectors continue to offer the best visibility into earnings even if we have a mild recession next year. While slowing economic activity will likely act as an anchor for small-capitalization stocks in the near term, small caps should be ready to set sail at some point in the first half of next year as economic activity bottoms and then subsequently improves.

Internationally, we still prefer the US because of the macro backdrop—a more resilient and dynamic US economy should limit the downside to economic growth and lead to a faster recovery. In addition, US companies tend to be more technologically advanced and have greater profitability/efficiency which should help to navigate in the upcoming choppy environment. However, there are several opportunities on the global landscape that are still worth exploring. For centuries, finding the shortest route to India was every sailor's dream. Portuguese explorer Vasco de Gama, the first European to sail around the Cape of Good Hope to India, realized the dream, establishing valuable trade relations. Now instead of spices, India offers opportunities in technology

and 'friendshoring' especially with the shift away from China and should benefit from favorable demographics. Select areas of Latin America (e.g., Mexico and Brazil) should benefit from elevated commodity prices and their respective central banks easing monetary policy.

When it comes to investing, it takes skill to navigate the tension between going faster versus making a wrong-footed move and running aground. In uncertain times, don't try to learn the ropes on your own—we all need a crew! Your financial advisor can provide the compass to guide you through investing challenges. Finally, we want to remember one of the most fun sailors of all time, Jimmy Buffett. Here's a "Parrothead" wish from us to you: may you reach your financial goals early so you can enjoy that "It's 5 O'Clock Somewhere," eat a "Cheeseburger in Paradise," and spend vacations in "Margaritaville"!

*Wishing you fair winds and following seas,*



**Lawrence V. Adam, III, CFA, CIMA®, CFP®**  
Chief Investment Officer

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# Redefining Resilience: The Unstoppable Consumer

Eugenio J. Alemán, Ph.D., *Chief Economist*, Raymond James  
Giampiero Fuentes, *Economist*, Raymond James

High interest rates and elevated rates of inflation seem to be good textbook examples of factors that would negatively impact consumer spending, as higher borrowing costs and more expensive goods reduce consumers' purchasing power. However, fiscal policy in the form of money transfers meant to cushion any potential downfall due to the pandemic has propelled consumers to continue to spend over the last three years. Furthermore, households added almost \$3 trillion in household debt since the pandemic began, with credit card debt reaching an all-time high of \$1 trillion, motor vehicle loans surpassing \$1.5 trillion and housing debt soaring past \$12 trillion. Overall, these increases in household debt pushed total debt per capita higher by ~\$8,000 since the beginning of the COVID pandemic. Finally, the last tailwind for the consumer, former President Trump's COVID-19 emergency relief for federal student loans (extended by both President Trump and President Biden), ended on September 1. Therefore, with excess savings completely exhausted, and highly

restrictive financial conditions, how can consumers sustain their current spending habits? While the situation isn't as dire as the headline numbers might suggest, the quick answer is because of the flow of income that comes from a strong labor market; i.e., 'employment.'

## FADING FORTUNES

Before we dive into the consumer, it is important to analyze how the economic landscape has changed during the last three years, and most importantly, how different this 'return to normal economic conditions' will be. The COVID pandemic fundamentally changed economies around the world and has arguably impacted the consumer the most. After periods of lockdowns, supply-chain disruptions that reduced the supply and consumption of goods, an overall inability to consume services, and yet lots of fiscal policy, the disposable income of US households peaked at almost \$22 trillion in March 2021. An estimated \$2.2 trillion of excess savings were accumulated during the pandemic, and what happened after the US economy and the world reopened can only be described as

## The Cost of Debt Service Has Declined Since the Great Recession



years of ‘revenge spending.’ Our research suggests that as of August, the excess savings that households accumulated during the pandemic have been fully depleted. Nevertheless, if employment remains as strong as it is today, it will be enough to support consumer demand, as well as economic growth.

### DEBT MATTERS, BUT EMPLOYMENT MATTERS MORE

While wages and salaries, as well as excess savings due to fiscal transfers, took care of many expenses during the last two years in support of this ‘revenge spending,’ household debt has increased to over \$17 trillion according to the Quarterly Report on Household Debt and Credit. Despite the size of this number, total household debt in the US as a percentage of GDP is lower today than it was during the Great Financial Crisis. Moreover, the cost of servicing household debt—made up largely of fixed low-interest-rate mortgages taken out before or during the pandemic—is at one of the lowest points in recorded history, which gives individuals and households the ability to continue to consume more at the same level of income.

Although interest rates have gone up, more than 82% of US households have a mortgage with a rate below 5%. Similarly, auto loans have a set interest rate that in most cases is locked in the mid-single digits. On the other hand, credit card debt is dangerous to consumers because it carries the highest interest rate, on

average over 20%. Therefore, this is something that could become a headwind for consumer spending in the future if delinquencies on credit cards were to increase. Currently, 30 or more days late delinquencies are above 7%, but total debt delinquency continues to remain at ~3%, near pre-pandemic average levels.

What about a type of debt that some borrowers haven’t had to repay in over three years? We are talking about student loan debt repayment that has now restarted. Although there were about 44.5 million individuals with student loan debt as of Q2 2023, about 27.4 million were in forbearance (principal payments postponed or reduced) by the second quarter of 2023 while 6.5 million were “cumulative in default,” which are loans that are more than 360 days delinquent. Six million students are still in school, so they do not have to start paying yet, one million are in the six-months grace period after no longer being in school and 300,000 individuals are still repaying their loans. Furthermore, 3.1 million individuals were in ‘deferment,’ which means that their monthly payments have been temporarily suspended or “reduced as a result of certain types of financial hardships.” Therefore, up to about 27.4 million student loans are expected to resume payments in October, not 44 million as some reports have indicated.

On average, student loan monthly payments for undergraduate college degrees are in the vicinity of \$200.00, with higher

“Today, while we are expecting employment to weaken going forward and consumption to slow, the US economy has continued to get support from several fiscal bills, such as the CHIPS Act, the Inflation Reduction Act (IRA), and the Infrastructure Bill, which have all contributed to keeping investment from responding more severely to higher interest rates.”

estimated payments if the student loan was for graduate studies or if it also included graduate studies. Our estimate in the table below assumes that, despite the one-year leniency program, if every one of the 27.4 million borrowers starts repaying their loans at \$200/month, the impact that this reduction in disposable income would have on personal consumption expenditures, and ultimately on GDP, is very small.

Our estimates show that even if all borrowers start paying their full monthly payment of \$200, the impact would be a reduction in GDP growth of 0.1% in 2023, and 0.2% in 2024, other things constant. In the unlikely worst-case scenario, where borrowers’ monthly payment is twice as much as what our base case is, the impact would be a reduction in GDP of 0.1% in 2023, and 0.4% in 2024, other things constant.

**THE OUTLOOK ON THE CONSUMER AND THE ECONOMY: IT IS ALL ABOUT JOBS!**

Economic growth in the US is driven primarily by consumer spending, which accounts for ~70% of GDP. What allows consumers to spend is their disposable income, which under normal circumstances (i.e., no fiscal transfers like those that occurred during the pandemic) is directly tied to the labor market. When people are employed, they earn wages and salaries, which contribute to overall income. Employment and personal consumption expenditures have a correlation higher than 90%, suggesting that if employment continues to grow, personal consumption expenditure should remain, at worst, stable.

Economic growth in the US is driven primarily by consumer spending, which accounts for ~70% of GDP.

Furthermore, as long as the labor market remains strong, there are alternatives (obtaining a second or part-time job, gig economy, etc.) for individuals to complement their income and keep consumption going.

As the impact of restrictive monetary policy slows the economy further into a very mild recession, our expectation is that the labor market will continue to slow down and contract slightly starting in January of 2024. In total, we expect the number of job losses to be around 500,000, which would be the smallest number of jobs lost during a recession. On average about 3.5 million jobs are lost during an economic downturn, with the worst in recorded history being the 20 million jobs lost during the Great Financial Crisis or Great Recession.

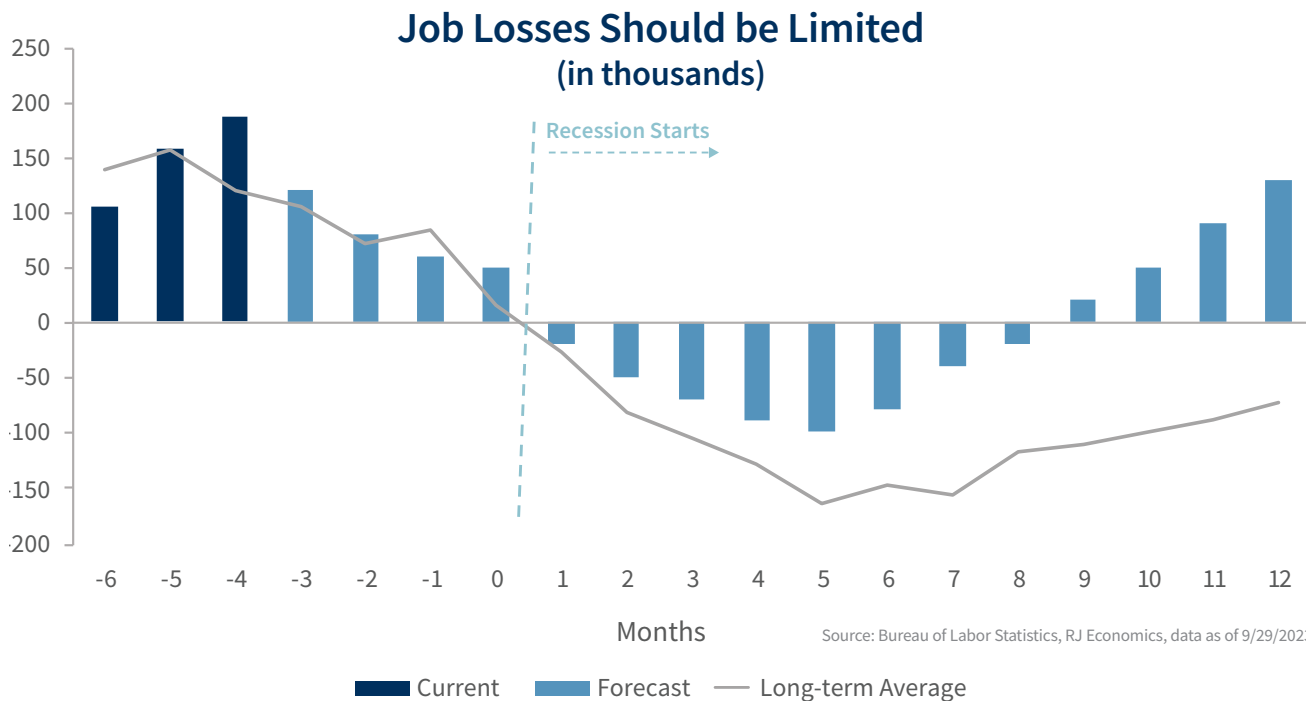
The lifeline of the consumer is income, and while we expect employment to weaken in the short term, consumers are likely to be able to continue to consume if the slowdown in employment is mild, as we are expecting. Restrictive monetary



**EFFECT OF STUDENT LOANS ON GROSS DOMESTIC PRODUCT FORECAST**

	2023	2024
<b>Current Forecast</b>	2.1%	0.4%
<b>\$200/month</b>	2.0%	0.2%
<b>\$400/month</b>	2.0%	0.0%

Source: National Student Loan Data System (NSLDS), RJ Economics, data as of 6/30/2023

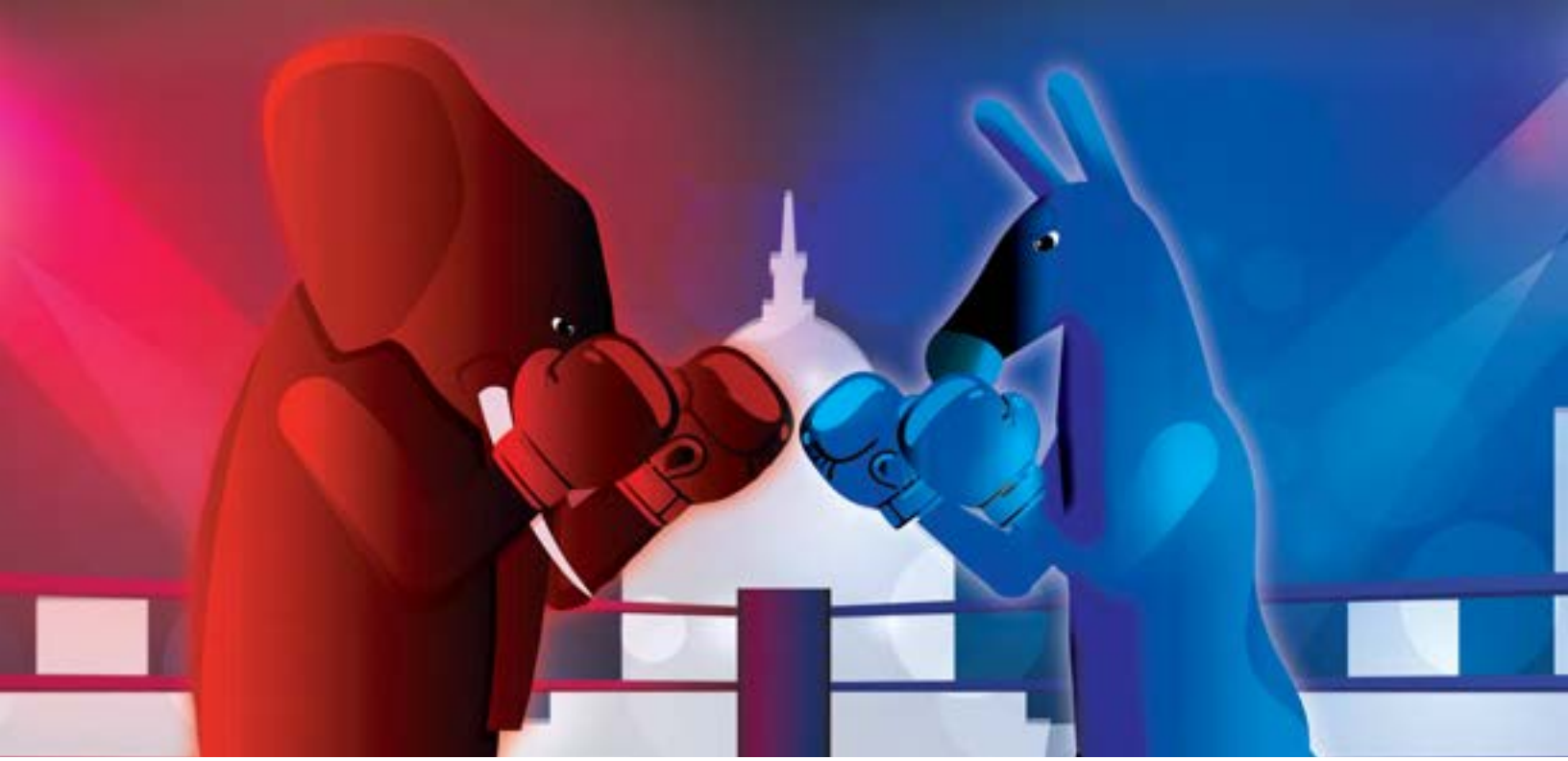


policy is making it increasingly more expensive to borrow, effectively reducing the consumer’s ability to borrow to support higher consumption. The same is also true for businesses. If employment weakens or if it contracts moderately, as we expect, many individuals will have trouble paying back debts and this will put pressure on economic activity. The good news is that typically, in a recession, automatic stabilizers (unemployment benefits, welfare programs, etc.) will soften the burden for those who lose their jobs. This is why, during economic slowdowns, the consumer impact is typically moderate.

The bottom line: The consumer is the backbone of the US economy, and consumer spending's resiliency contributed to economic growth as the US economy exited the COVID-19 pandemic recession. Today, while we are expecting employment to weaken going forward and consumption to slow, the US economy has continued to get support from several fiscal bills, such as the CHIPS Act, the Inflation Reduction Act (IRA), and the Infrastructure Bill, which have all contributed to keeping investment from responding more severely to higher interest rates. Although we believe that the effects of these bills are going to dwindle in the near future, the effects on economic activity may linger for several more quarters. ■

#### KEY TAKEAWAYS:

- Despite high interest rates and elevated levels of inflation, fiscal policy and money transfers meant to cushion any potential downfall due to the pandemic have propelled consumers to continue to spend over the last three years.
- Consumers have been able to continue to spend because of the flow of income coming from employment.
- What happened after the COVID pandemic can only be described as revenge spending; however, excess savings have now been depleted. Nevertheless, if employment remains as strong as it is today, it will be enough to support consumer demand, as well as economic growth.
- Household debt has increased but as a percentage of GDP is still lower than during the Great Financial Crisis and the cost of debt servicing is the lowest it has ever been.
- The lifeline of the consumers is income, and the consumer is the backbone of the US economy. The consumer's resiliency contributed to economic growth as the US economy exited the COVID-19 pandemic recession.



# First Look at the 2024 Race: A 2020 Rematch?

Ed Mills, *Managing Director, Washington Policy Analyst*

The 2024 election is well underway and signs currently point to a 2020 ballot rematch between President Biden and former President Trump. An analysis of the dwindling number of competitive swing states shows just a handful likely to decide the outcome of the election—once again a potential repeat of 2020. The battle for majority control of the House and Senate is also showing signs of a close election, reflecting the slim majority in each house—likely decided on macro factors such as the winner of the presidential election, candidate quality, redistricting lawsuits, the economy, and views on the direction of the country. Control of both chambers of Congress remains important to the market, with tax cuts scheduled to sunset in 2025 and decisions on key judicial and regulatory confirmations awaiting the respective House and Senate majorities after the 2024 election. There are many wildcards ahead and we have lived through multiple elections where the conventional wisdom is upended more often than many of us would like to be reminded. In this update, we

outline some of the market implications of the 2024 election and whether certain historical markers can give us insight into who might have the edge.

## STATE OF THE PRESIDENTIAL RACE

At this stage in the race, President Biden is the expected Democratic nominee. On the Republican side, former President Trump has a sizable lead over his challengers for the Republican nomination. An analysis of voter preferences in previous nominating contests shows candidates with sizable leads at this point in the nomination process have all eventually captured their party's nomination, making former President Trump the favorite to represent the Republican Party in 2024.

More than a year out from Election Day, we generally look at the approval ratings of incumbent presidents and polling on “right track/wrong track” of the country as a proxy for their strength and/or vulnerabilities for reelection. For President Biden, there are some warning signs for his reelection, as he has a net negative approval rating and a majority of voters viewing the US as on the “wrong track.” On the other hand, all incumbent presidents in the last 80 years have been reelected, unless there is a recession. This



could make the trajectory of the economy over the next year particularly important for the reelection of President Biden. Other Democratic primary candidates have entered the race, but their candidacies do not pose a material threat to Biden’s path to the Democratic nomination at this stage. Concerns around Biden’s age have opened questions about what would happen if he had to drop out of the race. While an early withdrawal would see the Democratic National Committee (DNC) select a new nominee, a late-stage withdrawal would result in legal uncertainties around what electors can do. If Biden withdraws, a large field of both nationally prominent and rising star candidates are waiting in the wings.

As mentioned, we view former President Trump as the most likely Republican nominee, as the increasingly crowded Republican primary field is not yet presenting a real challenger to the former President’s significant lead in the polls. The outcome of various legal challenges for President Trump could alter the race, but we are in unprecedented times as it relates to these trials. As stated above, the approval rating of an incumbent president can be a proxy for the outcome of the general election and was a warning sign in 2020 for President Trump. There are a limited number of times where a former president has sought to win a second non-consecutive term and former President Trump also has a net negative approval rating similar to President Biden.

A third-party run could further disrupt the playing field, acting as a ‘spoiler’ factor that could sap votes from the mainstream candidates and potentially swing the election.

President Trump in the last two presidential elections. The current 51-49 Democratic majority would flip if Republicans net two seats or one seat and win the presidency (as the Vice President is a tiebreaker). Candidate quality, which has been an issue in recent Senate races, will loom large in several of these, but with Senate races closely aligning with the presidential preference of the state, Republicans have an edge.

In the House, where all 435 seats are on the ballot, Democrats would have to flip six seats to win a majority. Historical precedent may provide tailwinds to Democrats, given that over the past 40 years, the House’s majority party (currently Republican) has lost an average of three House seats in presidential election years. At this point, the most important factors in control of the House are the ongoing court challenges to congressional maps, potentially switching several safe Republican seats over toward Democratic seats.

### RACE FOR THE HOUSE AND SENATE

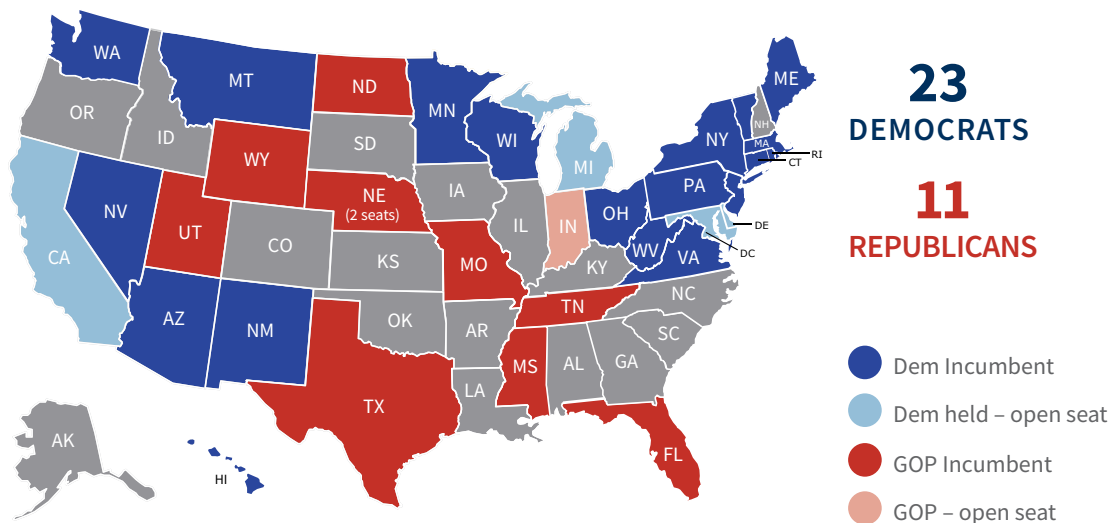
There are 34 of the 100 Senate seats on the ballot in 2024, with Democrats defending 23 and Republicans 11. Among the most competitive seats, all are currently held by a Democrat, including seats in Montana, Ohio, and West Virginia—all states won by

### WHAT TO WATCH AND POTENTIAL WILDCARDS

The state of the race will continue to be fluid until the election, but key factors in the coming months will shape the race’s trajectory.

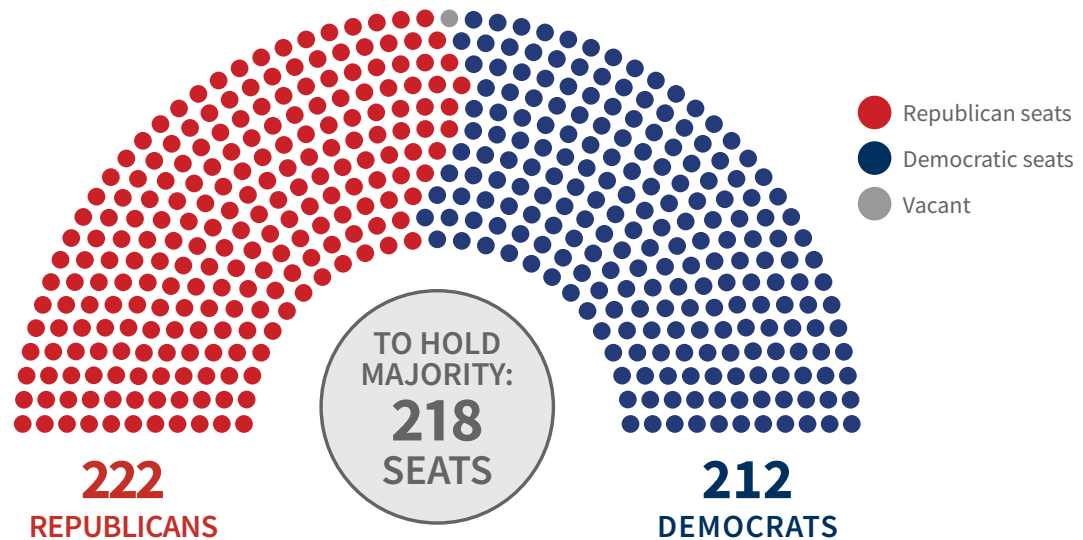
## The Senate

**CURRENT SENATE: 51 DEM, 49 GOP; DEM +1**



Source: MapChart, Raymond James Research

## The House of Representatives



As the 2024 cycle progresses, the primary debates will offer a key look into whether a challenger to former President Trump can emerge. Economic factors in the coming months will also play a critical role in determining the headwinds Biden faces, given that only four presidents have lost their second-term reelection bid in the last 80 years and all of them experienced recessions/lower consumer confidence during their first term.

Key market issues for investors to watch will include headline risk around the appropriations process in DC and the impacts of a potential government shutdown.

Broader trends to watch include candidate quality in the race for the Senate, given that Republicans have experienced losses close races (particularly in 2014 and 2022) by nominating candidates in key swing states with limited general election appeal. A third-

party run could further disrupt the playing field, likely acting as a 'spoiler' factor that could sap votes from the mainstream candidates and potentially swing the election. Historical precedent has not seen third-party candidates receive electoral college votes on a material scale since 1968. An analysis of the 2016 and 2020 election points to a third-party candidate to have a bigger draw of votes away from President Biden. A growing number of voters with preferences for outside candidacies or issue-specific platforms could gravitate to a third-party candidate.

As the electoral cycle progresses, other key market issues for investors to watch will include headline risk around the appropriations process in DC and the impacts of a potential government shutdown. As the divided Congress continues to debate funding levels and spending priorities for the 2024 fiscal year, we expect to see brinkmanship around the finer details, but view any funding impasse resulting from a shutdown as unlikely to have material near-term market impacts. However, potential dysfunction may impact voter sentiment down the line, with specific impacts on the Congressional race depending on how a potential shutdown unfolds. ■

### KEY TAKEAWAYS:

- The 2024 presidential race is looking like a 2020 rematch between President Biden and former President Trump.
- Democrats hold a slim 51-49 majority in the Senate and are defending 23 Senate seats, so any losses could tip the balance of power.
- Republicans hold a majority in the House. Democrats would need to flip six seats to take control.
- Risk of a government shutdown continues to hang over Washington and will affect voter sentiment.



# Adapting To A Water Shortage

Pavel Molchanov, *Managing Director, Equity Analyst*, Equity Research

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Epic heat waves have been arguably the number one source of headlines around the world throughout this past summer: June 2023 was the hottest month in recorded human history... until it was topped by July. This is only the latest illustration of a long-term megatrend: global heating. Among the many consequences of the climate crisis is more widespread and severe droughts—or, to put it even more starkly, water scarcity. In thinking about the climate crisis, we need to differentiate between two types of responses: climate mitigation and climate adaptation. Mitigation is about how to keep the climate crisis from becoming even worse, with solutions that include shifting away from coal-fired electricity toward renewables and from the internal combustion engine toward electric mobility. This article, however, focuses on adaptation: how governments, businesses, and all of us as individuals need to adapt to the reality of rising temperatures. Arguably the most important aspect of adaptation pertains to the water industry's value chain.

## **WATER, WATER EVERYWHERE?**

The International Institute for Applied Systems Analysis forecasts global water demand increasing by an average of 0.6% per year between 2010 and 2050, or 26% in total. By contrast, aggregate water availability does not change in any meaningful way over the long run. With this in mind, an important metric, calculated by the World Resources Institute, is what's known as baseline water stress. This is defined as total water demand (residential, commercial/industrial, agricultural) divided by water supply from conventional sources (rainfall and underground aquifers). The higher the ratio of those two numbers, the more water stress there is. Unsurprisingly, the situation is the most problematic in arid regions such as the Middle East. Looking at the G20 major economies, Saudi Arabia is at 5.0, followed by South Africa at 4.2. On the other end of the spectrum, Brazil and Canada have what we might call balanced water markets. The US at 2.6 and China at 2.8 are near the middle of the list. To be clear, that is the situation as it is right now — but it is getting worse just about everywhere. Demand growth is led by emerging markets, and a disproportionately large share of the incremental demand is coming from manufacturing rather than irrigation. The World Bank has predicted that water scarcity will afflict large swaths of Africa, the Middle East, and Asia by 2050, with GDP impact of up to 6%.

At the risk of overloading our readers with technical lingo, we need to introduce another metric: water dependence ratio, which is defined as the percentage of total renewable water resources that originate outside the country. This pertains to the geopolitical dimension of water scarcity. As much of a hot-button issue as energy security has been in recent decades, water security is just as important, if not more so. In this regard, China is in a very good position, as its dependence ratio is a mere 1%. By contrast, India is at 31% and Pakistan at a whopping 78%. The latter two nuclear powers already have a rather strained relationship, to put it mildly, and competition for scarce water resources is only getting underway. Similarly, though without the risk of nuclear confrontation, it is not difficult to imagine water-related conflicts among several countries in Southeast Asia.


Water scarcity is a far-reaching problem that demands a wide variety of solutions to address it. We deliberately use the word ‘address’ rather than ‘solve’ — even under an optimistic scenario, this environmental challenge, like so many others, will be here to stay. Broadly speaking, the solutions can be divided into demand-side and supply-side categories.

**BASELINE WATER STRESS FORMULA**

$$\frac{\text{Total water demand}}{\text{Water supply}} = \text{Baseline water stress}$$

**WATER DEPENDENCE RATIO**

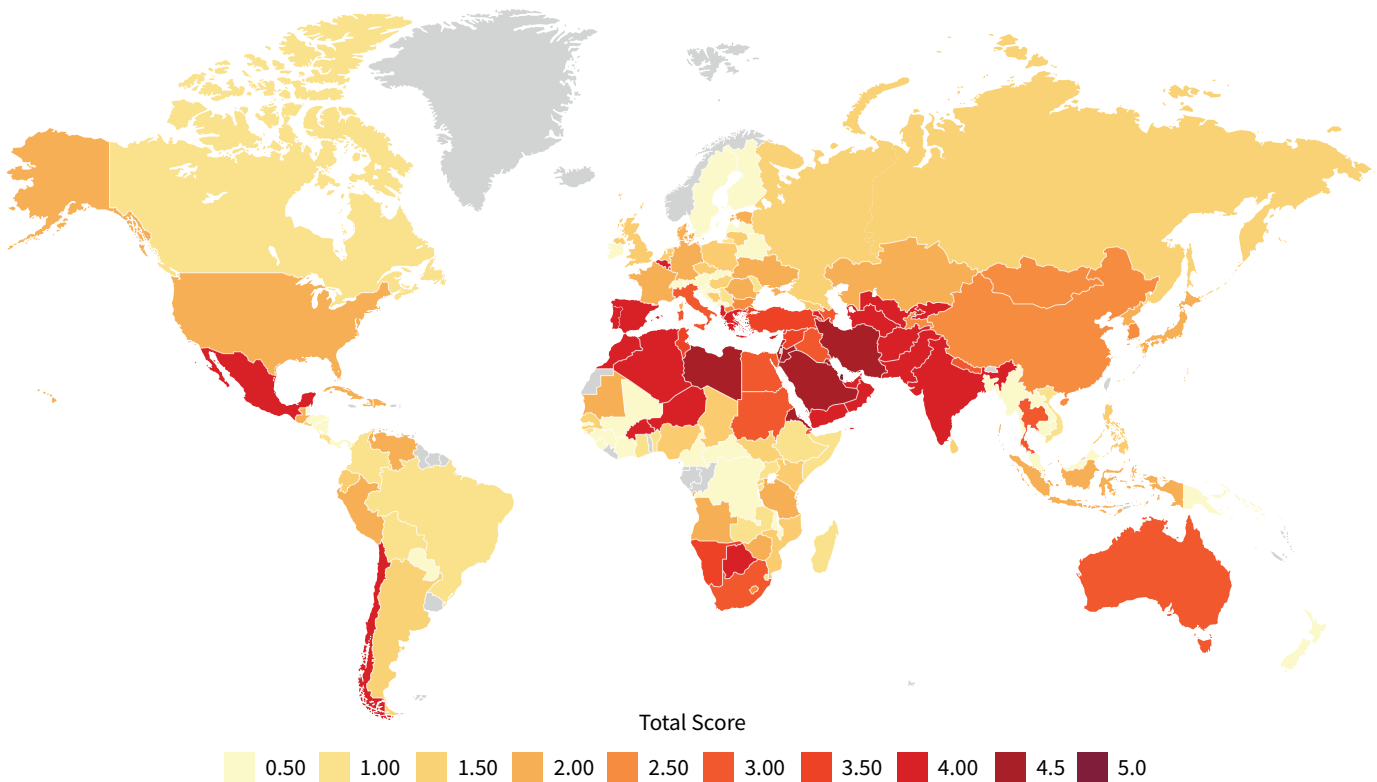
$$\text{\% of water resources originating outside of the country} = \text{Dependency ratio}$$



**WATER SCARCITY SOLUTIONS**

On the demand side of the value chain, water usage can be optimized via improved planning and incentives, thereby avoiding the knee-jerk response of emergency rationing after a genuine crisis emerges. Some of our readers may remember the ‘Day Zero’

**Water Stress By Country – 2023**



Source: World Resources Institute



“More than one-third of the water provided by utilities in some communities is never actually paid for—it either disappears via leaky pipes or is erroneously measured.”

crisis in Cape Town, South Africa in 2018, though in terms of scale, it pales in comparison to what happened in Tamil Nadu, India in 2019 and parts of Pakistan in 2022. But even something as simple as water metering—a prerequisite for monitoring usage—is far from universal. This, along with outdated drinking water infrastructure, helps explain why the amount of non-revenue water is as high as it is: estimated at up to 40% in emerging markets. In other words, more than one-third of the water provided by utilities in some communities is never actually paid for—it either disappears via leaky pipes or is erroneously measured.

The main supply-side solutions are wastewater recycling and desalination. Wastewater recycling, also called reclaimed water, can be used for non-potable purposes (e.g., agriculture) or direct human consumption. The latter tends to be controversial among the general public. Israel, Namibia, and Singapore are among the leaders in the percentage of water supply that is reclaimed. There is no fundamental reason why this technology cannot scale in China and India, but it remains a work in progress. As compared to wastewater recycling, desalination is more geographically widespread, though only 1-2% of the world’s population relies on desalinated water. Desalination has traditionally been most prevalent in the Middle East: Saudi Arabia and the UAE are near the top of the capacity rankings in absolute terms, and Israel and Malta have notably high shares of water supply coming from desalination. Adoption is on the rise in China and India, but less rapidly than you might think. During the period 2016-2020, China (population: 1.4 billion) built less desalination capacity than the UAE (population: 10 million), and India was even further behind.

#### HYDRO POWER: NO LONGER A GROWTH DRIVER

There is one final aspect of water scarcity that needs to be mentioned, and that is the impact on hydropower generation. Global heating translates into reduced flow of water in rivers, and that in turn leads to diminished hydro output. The impact on the world’s electricity supply—especially in the Western Hemisphere—is underappreciated. Hydro provides approximately 60% of the electricity in Brazil and Canada. Vietnam, Turkey, Russia, and Argentina are all between 15% and 40%, and China—which has the world’s highest electricity consumption in absolute terms—is right at the global average of 15%. While it is too early to know for sure, there is a plausible scenario that global hydro output has already peaked. In other words, this portion of the electricity mix can never again be looked at as a growth driver. In this context, there is a crucial difference between hydro and non-hydro renewables. Wind and solar generation are intermittent on a short-term basis, but they do not face hydro’s structural headwinds. Thus, wind and solar need to play a role in displacing not only coal (a subset of climate mitigation) but also hydro (a case study of adaptation). ■

The World Bank has predicted that water scarcity will afflict large swaths of Africa, the Middle East, and Asia by 2050, with GDP impact of up to 6%.

#### KEY TAKEAWAYS:

- Water security is a geopolitical issue like energy security.
- Water stress is most problematic in the Middle East and parts of Asia, but it is worsening everywhere over time.
- Water usage can be optimized via improved planning and incentives, thereby avoiding the knee-jerk response of emergency rationing after a genuine crisis emerges.
- The main supply-side solutions are wastewater recycling and desalination.



## Q&A: Cracks in Commercial Real Estate? Not Everywhere

Bishop Jordan, *Senior Credit Analyst*, Raymond James Investment Management\*

The shift to remote and hybrid work during the pandemic has shaken up commercial real estate (CRE) and now the cracks are starting to deepen, even as businesses push employees to return to the office. Investors drive by “for sale” signs on high rises, defaults on commercial loans are rising, and debt refinancing is more expensive. Outstanding commercial real estate loans total \$2.9 trillion.\*\* Smaller regional banks with those loans on their balance sheets could also feel the pinch.

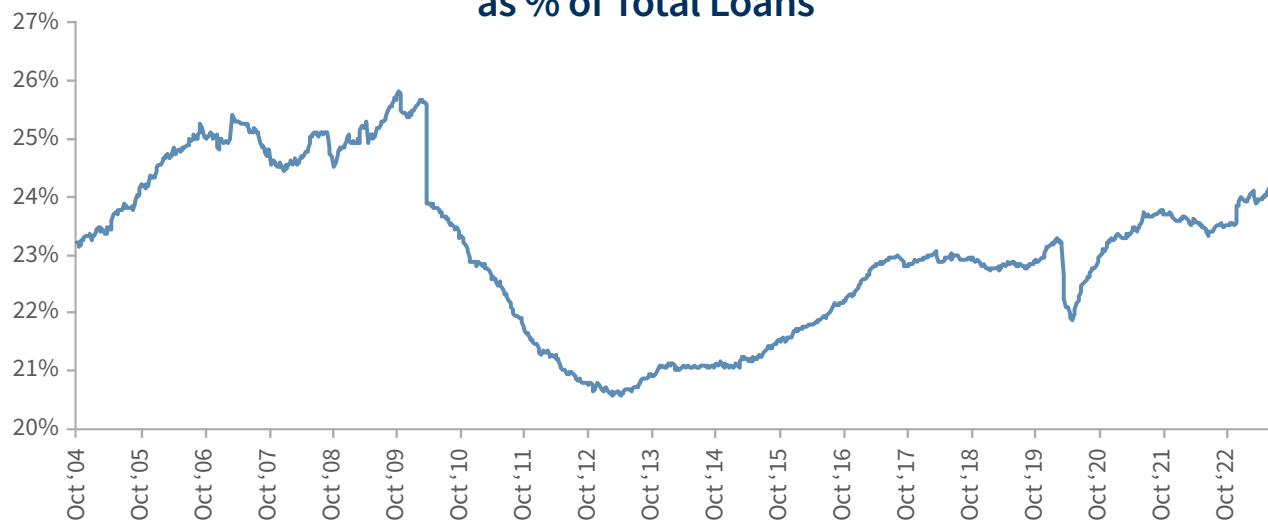
We asked Bishop Jordan, Senior Credit Analyst and Co-Portfolio Manager at Raymond James Investment Management,\* to walk us through the risks—and opportunities—in commercial real estate.

### Q. How did commercial real estate reach this apparent crisis point?

A: Work from home is the biggest factor. You see big companies now pushing to get people back to the office, but remote work has been a huge cultural shift. And it’s not just office buildings that are affected; it’s an entire real estate ecosystem that dries up. Workers also stop going to restaurants and other businesses around their offices. According to Bloomberg, New York City subways are still only 70% full on weekdays and only about half of workers are back at buildings compared with pre-COVID levels.

In many cases remote work has allowed workers to move farther from their workplace. More employees have moved from New York or California to states like Florida and Texas. Companies are even shifting their business centers away from Wall Street. It hasn’t come to the point where businesses in New York are saying “Take the keys to our headquarters, we’re out of here,” but they are getting squeezed.

## Commercial Real Estate Loans as % of Total Loans



Source: FactSet, RJ Economics as of 9/19/2023

A lot of the distress in commercial real estate is regional—it depends where you are. For example, in New York City there are a lot more empty commercial office buildings. In Miami, there are fewer empty office buildings. So the office market in Florida is fine. Texas is fine. The office market in New York is not fine.

**Q. The office market isn't the only thing that makes up commercial real estate, even if empty offices are grabbing headlines. How much of a risk does office space pose to CRE as a whole?**

- A. There are pockets of weakness and pockets of strength. A lot of these office buildings over the past three to five years have been funded with mortgages, and whether that's on a bank balance sheet or in the CMBS market, those mortgages have floating rates. If there's an interest rate hedge against it, great, but if not, those interest rates are still going to go up even as rents are unchanged or going down.

If office space continues to weaken, I do not anticipate a contagion situation throughout the real estate sector. You

would have to see the additional areas of CRE collapse—industrial, multifamily, storage, and data centers—and those areas are not under the same pressure.

**Q. What are the bright spots in commercial real estate?**

- A. Infrastructure, like data centers and cell towers, are doing really, really well right now. REITs that own the land under casinos are doing very well, also. Public storage has done very well, along with cold storage, although some of these are sort of niche markets. Multifamily should be fine, but we are starting to see rents plateau.

**Q. What about banks with exposure to CRE? We saw Moodys downgrade several regional banks, at least in part due to their exposure to commercial real estate.**

- A. As far as banks go, they'll feel some pain, but it won't be dramatic for larger banks. Smaller regional and state-centric banks will feel more pain because they're smaller, and depending on what region they're in.

## BRIGHT SPOTS IN REAL ESTATE



Data centers and  
cell towers



Casinos



Public storage and  
cold storage

**Q. There's some lingering fear after the Great Financial Crisis, which started in real estate with people not paying their mortgages, then metastasized due to structured products based on those mortgages, and bets made on or against them. What are the key facts that make the CRE situation different?**

**A.** Those residential mortgages held by banks at 100% loan-to-value were packaged into securities by Wall Street and ended up being completely worthless. That's not the case with current commercial mortgages and commercial mortgage-backed securities (CMBS).

Also, the banks that went bust and pulled down the economy were focused on residential mortgages and were not diversified. Now, banks are more diversified and have other lines of business that diversify their earnings stream. New regulations mean banks are better capitalized, even if that means they have to tighten lending. Banks have the ability over time to offset any hits from CRE weakness with earnings from other areas. Even if CRE weakens further, this is not a sequel to the Great Financial Crisis.

**Q. Where do you see CRE going from here?**

**A.** We are keeping an eye on the office space risk, of course, and exploring opportunities in infrastructure and elsewhere. It's going to be more institutional investors affected by risks in CRE, and they have a longer-term investment horizon to absorb more risk.

You could see certain CMBS deals that have exposure to certain properties that will get impacted negatively. For example, there could be an office-backed commercial mortgage loan that is forced to renegotiate its debt with the loan holder. This is basically the equivalent of handing the keys to the lenders. As far as banks are concerned, we don't anticipate some sort of domino effect of failures among regional banks exposed to CRE.

The real estate issue will likely play out over many quarters, if not many years. We don't see an immediate hit overnight, and some of it will be focused on different regions of the US. So, there will be a lot of 'yin and yang,' a lot of forces that counteract or offset others. ▀

“Even if commercial real estate weakens further, this is not a sequel to the Great Financial Crisis.”



## Economic Snapshot

Although headline inflation increased on a year-over-year basis for a second consecutive month in August, core consumer inflation continued its slow disinflationary process. Shelter costs continue to weaken on a month-over-month basis, and we expect this weakness to persist during the rest of the year and aid core prices further. However, higher oil and gasoline prices are putting pressure on the headline number. Since economic growth has remained stronger than expected during the third quarter of the year, we have moved the start of our mild recession to the first quarter of 2024 due to the strength in nonresidential investment as well as the exhaustion of excess savings accumulated during the COVID-19 pandemic. We do expect higher interest rates to start affecting investment and consumption soon and thus we continue to expect a very mild recession that will last for two consecutive quarters. We expect the Federal Reserve (Fed) to increase the federal funds rate once more before the end of 2023 by 25 basis points and remain on hold during the first half of 2024. Downward employment revisions have put the labor market on a weaker path, but we are not expecting job losses until next year. The US dollar has strengthened somewhat and this will help reduce the inflationary effects of higher oil prices. However, higher-than-target inflation remains one of the bigger risks for policymakers as well as for the economy.

**EUGENIO J. ALEMÁN, PhD**  
Chief Economist

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	THE DOLLAR	The US dollar has strengthened during the summer months, and softer global growth may prevent a sustained decline due to the US dollar's role as a safe-haven currency.
	GROWTH	GDP growth is expected to continue to moderate over the next several quarters and we expect a mild recession to start in 1Q24.
NEUTRAL	EMPLOYMENT	Nonfarm payrolls have remained strong during the year's first half, but the labor market has been cooling down and we expect it to start contracting in 2024.
	CONSUMER SPENDING	Consumer spending has remained relatively strong, but it is likely to weaken since excess savings from the pandemic are fully depleted and student debt repayments will resume.
	BUSINESS INVESTMENT	Despite higher interest rates raising borrowing costs, the passage of several bills last year, including the Inflation Reduction Act (IRA), the CHIPS Act, and the infrastructure bill are contributing positively to business investments.
	HOUSING AND RESIDENTIAL CONSTRUCTION	High mortgage rates and rising construction costs due to a scarcity of construction workers are negatively impacting the housing industry. Despite these headwinds, the low supply of homes is keeping prices stable.
	INFLATION	Inflation is likely to continue to stabilize as economic activity weakens over the next quarters. Shelter costs should slow down further and barring any economic shock, headline inflation should go lower over the next several quarters.
	MONETARY POLICY	The Fed remains very hawkish and is likely to have at least one more hike before reaching its terminal rate and keeping rates higher for several more months.
	LONG-TERM INTEREST RATES	The yield curve remains deeply inverted as expectations for Fed rate hikes continue to linger. We expect the curve to remain inverted until the Fed pivots to an easier policy stance next year; however, longer-maturity yields should gradually decline as growth and inflation decelerate.
	FISCAL POLICY	The debt ceiling issue is now in the rearview mirror, and contributions to GDP from government spending this year are unlikely to change significantly.
	REST OF THE WORLD	We continue to expect a weakening global economy during 2023 as central banks either increase or hold interest rates high.
UNFAVORABLE	MANUFACTURING	Although the ISM Manufacturing Index remains in contraction, manufacturing output, as measured by the manufacturing production index, has remained positive but weak.

## Sector Snapshot

This report is intended to highlight the dynamics underlying the 11 S&P 500 sectors, with a goal of providing a timely assessment to be used in developing your personal portfolio strategy. Our time horizon for the sector weightings is not meant to be short-term oriented. Our goal is to look for trends that can be sustainable for several quarters; yet given the dynamic nature of financial markets, our opinion could change as market conditions dictate.

Most investors should seek diversity to balance risk versus reward. For this reason, even the least-favored sectors may be appropriate for portfolios seeking a more balanced equity allocation. Those investors seeking a more aggressive investment style may choose to overweight the preferred sectors and entirely avoid the least favored sectors. Investors should consult their financial advisors to formulate a strategy customized to their preferences, needs, and goals.

These recommendations will be displayed as such:

**Overweight:** favored areas to look for ideas, as we expect relative outperformance

**Equal Weight:** expect in-line relative performance

**Underweight:** unattractive expectations relative to the other sectors; exposure might be needed for diversification

For a complete discussion of the sectors, please ask your financial advisor for a copy of *Portfolio Strategy: Sector Analysis*.

**J. MICHAEL GIBBS**  
Managing Director, Gibbs  
Capital Management\*

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	HEALTH CARE	13.2%	Health care is a favored 'defensive' sector to water-down potential volatility in the current environment, given that valuation is much cheaper than other low-beta areas. Recent comments from companies regarding improved supply and labor issues, along with normalizing hospital utilization and medical demand, provide some optimism on fundamental trends.
	COMMUNICATION SERVICES	8.9%	Communication Services continues to act as market leadership, supported by improved earnings trends this year—and a solid Q2 earnings season saw sector estimate revisions take another leg up. With Communications Services still 20% off its highs and trading below its 10-year average P/E multiple, we maintain an Overweight recommendation.
	INDUSTRIALS	8.3%	We want to build exposure to what we believe will be a major theme over the next economic cycle; i.e., US onshoring and infrastructure buildout (AI, semis, EV, etc.). We acknowledge the economic risks ahead, but Industrials' recent price breakout and relative strength, in conjunction with positive earnings trends, support an increased stance.
	ENERGY	4.6%	Downward trending oil prices, resulting in downward earnings revisions, are headwinds to sector performance. Low valuation and still robust free cash flow generation keep us from becoming too negative.
EQUAL WEIGHT	INFORMATION TECHNOLOGY	27.3%	Fundamental strength and AI enthusiasm are undeniable for Technology, and we would look to accumulate on a pullback. But after a 20+% move over the past two months, the group is at overbought levels. We stay with an Equal Weight, which is still sizable portfolio exposure in the market's largest weighting.
	CONSUMER DISCRETIONARY	10.8%	Consumer resiliency has become more questionable in our view. Q2 retail earnings were consistent with a 'bend but not break' theme to consumer spending. Back-to-school spending was encouraging for potential holiday spend in the 2nd half of 2023, but there were also mentions of higher consumer credit card delinquencies, inventory shrink from organized theft, and trade-down in spending toward the value segment. The sector remains in an uptrend, but participation has narrowed markedly of late, with higher oil prices and interest rates only adding to concerns.
	MATERIALS	2.5%	Global economic concerns and the potential for US dollar strength are headwinds to performance. Weak earnings and relative strength trends support a cautious stance.
UNDERWEIGHT	FINANCIALS	12.8%	Relative performance for the sector remains weak overall with banks continuing to act as a drag. Bank earnings trends are likely to remain negative, as tight lending and conservative capital management act as headwinds to sector fundamentals (and performance, in our view).
	CONSUMER STAPLES	6.6%	Earnings revisions remain lackluster as pricing power (the main source of its fundamental strength) fades. Also, despite market volatility since July, the sector continued to underperform, pushing to new relative lows.
	UTILITIES	2.5%	Utilities performance has been weakest of the more defensive sectors this year, contributed to in part by the group's higher sensitivity to rising interest rates. Valuation is no longer expensive and expected earnings growth is solid, but relative strength remains in a downward trend for now.
	REAL ESTATE	2.4%	Tight bank lending, high interest rates, and economic concerns place a cloud of uncertainty on the highly-levered Real Estate sector. Valuation is low; however, weak earnings growth and negative relative strength trends support an Underweight recommendation.

## DISCLOSURE

All expressions of opinion reflect the judgment of the author, the Investment Strategy Committee, or the Chief Investment Office and are subject to change. Past performance may not be indicative of future results. There is no assurance any of the trends mentioned will continue or forecasts will occur. The performance mentioned does not include fees and charges which would reduce an investor's return. Dividends are not guaranteed and will fluctuate. Investing involves risk including the possible loss of capital. Asset allocation and diversification do not guarantee a profit nor protect against loss. Investing in certain sectors may involve additional risks and may not be appropriate for all investors.

International investing involves special risks, including currency fluctuations, different financial accounting standards, and possible political and economic volatility. Investing in emerging and frontier markets can be riskier than investing in well-established foreign markets.

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While interest on municipal bonds is generally exempt from federal income tax, they may be subject to the federal alternative minimum tax, or state or local taxes. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax. Municipal bonds may be subject to capital gains taxes if sold or redeemed at a profit.

If bonds are sold prior to maturity, the proceeds may be more or less than original cost. A credit rating of a security is not a recommendation to buy, sell or hold securities and may be subject to review, revisions, suspension, reduction or withdrawal at any time by the assigning rating agency.

Commodities and currencies are generally considered speculative because of the significant potential for investment loss. They are volatile investments and should only form a small part of a diversified portfolio. Markets for precious metals and other commodities are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Investing in REITs can be subject to declines in the value of real estate. Economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments.

High-yield bonds are not suitable for all investors. The risk of default may increase due to changes in the issuer's credit quality. Price changes may occur due to changes in interest rates and the liquidity of the bond. When appropriate, these bonds should only comprise a modest portion of your portfolio.

Beta compares volatility of a security with an index. Alpha is a measure of performance on a risk-adjusted basis.

The process of rebalancing may result in tax consequences.

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